Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Campbell	Analyst:	Colin Stevens	Bill Number:	AB 569
Related Bills:	none	Telephone:	845-3036	Introduced Date:	2/19/99
		Attorney:	Doug Bramhall	Sponsor:	CA Business Properties Association

SUBJECT: Passive Activity Credits/Conformity To Special Rules For Real Property Business

SUMMARY

By conforming state law to current federal law, this bill would permit taxpayers involved in a real property trade or business who meet certain tests to treat rental real estate activities as nonpassive activities subject to limitation under the passive loss limitation rules.

EFFECTIVE DATE

This bill would apply to taxable or income years beginning on or after January 1, 1999.

BACKGROUND

A passive activity is any activity involving the conduct of any trade or business in which a taxpayer does not materially participate. Passive activity includes any rental activity. The rules on passive activity losses (PALs) limit deductions and credits from passive activities. Deductions attributable to passive activities, to the extent they exceed income from passive activities, generally may not be deducted against other income, such as wages, portfolio income, or business income that is not derived from a passive activity. A similar rule applies to certain credits. Deductions and credits that are suspended under these rules are carried forward and treated as deductions and credits from passive activities in the next taxable year. Losses from a passive activity are allowed in full when a taxpayer disposes of his entire interest in the passive activity to an unrelated person in a fully taxable transaction.

The passive loss limitation rules apply to individuals, estates and trusts, closely held C corporations, and personal service corporations. A special rule permits closely held C corporations to apply passive activity losses and credits against active business income (or tax liability allocable thereto) but not against portfolio income. For purposes of the California S corporation franchise or income tax, the passive loss limitation rules also apply to S corporations as if the S corporation were an individual (material participation of an S corporation in its activities is determined as if the S corporation were a closely held C corporation.)

SPECIFIC FINDINGS

Under state and federal law, passive activities are defined to include trade or business activities in which the taxpayer does not materially participate and any rental activity.

Board Position:			Department Director	Date
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Thus, all rental activities (including rental real estate activities) are treated as passive activities, regardless of the level of taxpayer's participation. A taxpayer materially participates in an activity for the taxable or income year only if the individual is involved in the activity's operations on a regular, continuous and substantial basis during such year and meets at least one of the following tests:

- Participation in the activity by the taxpayer is more than 500 hours;
- Participation in the activity by the taxpayer is substantially all of the participation in it by all individuals;
- Participation in the activity by the taxpayer is more than 100 hours and is not less than anyone else;
- The activity is a significant participation activity (SPA) for the tax year and the individual's aggregate participation in all SPAs is greater than 500 hours. A SPA is a trade or business in which the individual significantly participates in more than 100 hours, but in which he does not otherwise participate;
- The taxpayer materially participated in the activity for any five taxable years during the ten immediately preceding taxable years;
- The activity is a personal service activity and the taxpayer materially participated in the activity for any three preceding taxable years; or
- Based on all the facts and circumstances (taking into consideration the exceptions and limitations provided under the regulations), the taxpayer participates in the activity on a regular, continuous and substantial basis.

A special rule permits the deduction of up to $25,000 of passive losses from active participation rental real estate activities. This $25,000 amount is allowed for taxpayers with modified adjusted gross incomes of $100,000 or less, and is phased out for taxpayers with modified adjusted gross incomes between $100,000 and $150,000.

From their inception in 1986 until 1993, the passive activity provisions of the Internal Revenue Code have generally treated all rental activities as passive, regardless of the taxpayer's level of participation. However, **under federal law as amended in 1993,** a taxpayer's rental real estate activities in which he or she materially participates are not subject to limitation under the passive loss limitation rules if the taxpayer meets eligibility requirements relating to services performed in real property trades or business. The 1993 changes to federal law did not allow qualified real estate professionals to “unlock” passive activity losses incurred prior to January 1, 1994, and to thereby use such losses against nonpassive income generated after that date.

Real property trade or business means any real property development, redevelopment, construction, reconstruction, acquisition, conversion, rental, operation, management, leasing, or brokerage trade or business.

An individual taxpayer meets the federal eligibility requirements relating to a "real property trade or business" if:

(1) more than half of the personal services the taxpayer performs in trades or businesses during the taxable year are performed in real property trades or businesses in which the taxpayer materially participates, and

(2) such taxpayer performs more than 750 hours of services during the taxable year in real property trades or businesses in which the taxpayer materially participates.

A taxpayer who meets these eligibility requirements for a real property trade or business, also must meet at least one of the seven tests for material participation for each rental real estate activity which is determined to be nonpassive. In the case of a joint return, the eligibility requirements are met if either spouse separately satisfies the requirements. Thus, one spouse must satisfy both of the eligibility requirements, without regard to services performed by the other spouse. In determining material participation, however, there is no change to the existing rule that the participation of the spouse of the taxpayer is taken into account.

California law conforms to the federal passive activity rules with certain exceptions. California has never conformed to the special rules for taxpayers in real property trades or businesses. As a result, all rental real estate activities are treated as passive activities regardless of the taxpayer's occupation or level of participation.

Under the PITL and the B&CTL, **this bill** would prospectively conform state law to existing federal law with respect to the special rules for taxpayers in real property trades or businesses. Thus, **this bill** would permit taxpayers in real estate trades or businesses who meet specified eligibility requirements to treat as nonpassive rental real estate activities in which they materially participate. Under this bill, as under the 1993 federal changes, qualified real estate professionals would not be allowed to “unlock” passive activity losses incurred prior to the date of conformity to federal law (January 1, 1999,) to be used against nonpassive income generated after that date.

Policy Considerations

Conforming to federal tax law is generally desirable because it is less confusing for the taxpayer, particularly when dealing with complex areas such as PALs. Conformity also eases the department’s administration of the law by utilizing many federal forms and instructions. This bill would increase conformity, potentially making the calculation of tax easier for taxpayers.

Implementation Considerations

According to IRS staff specializing in passive losses, the addition of the special rules for taxpayers in real properties trades or businesses created significant noncompliance issues. These noncompliance issues are largely due to taxpayers incorrectly asserting that they qualify as real estate professionals and that they also materially participate in rental real estate activities.

Proper implementation of these special rules for taxpayers in real property trades or business as a result of this bill would suggest increased audit activity to verify whether taxpayers are accurately treating rental real estate losses as nonpassive.

Although IRS numbers for the amount of noncompliance are not available, according to IRS staff, such numbers are significant and similar implementation issues could be expected for California. An education program by the department may help in this area but would not resolve issues with taxpayers who take an aggressive filing position.

FISCAL IMPACT

Departmental Costs

This bill may require additional costs to educate taxpayers and to audit returns. This additional cost is not determinable but, based on IRS experience, could be significant if audit activity is sufficiently impacted.

Tax Revenue Estimate

Based on limited data and assumptions discussed below, this bill would result in the following revenue losses.

Estimated Revenue Impact of AB 569 As Introduced 2/19/99 [$ In Millions]			
	1999-00	2000-01	2001-02
PIT	($9)	($8)	($8)
B&CT	($1)	($1)	($1)
TOTAL	($10)	($9)	($9)

The bill would be effective with taxable/income years beginning on or after January 1, 1999, with enactment assumed after June 30.

This analysis does not consider the possible changes in employment, personal income, or gross state product that could result from this measure.

Tax Revenue Discussion

The number of qualifying real estate professionals who materially participate in rental real estate activities, the amount of otherwise nondeductible passive losses generated by the activity that, under this proposal, can offset other, nonpassive income, and the tax rates of qualifying taxpayers would determine the revenue impact of this bill.

For this issue, previous estimates have been based on prorated federal projections for the Revenue Reconciliation Act of 1993 (P.L. 103-66). Based on available tax return data, it now appears that estimated state impacts should be reduced to the levels shown above.

Using personal income tax sample data (1996 base), a methodology was developed to quantify the amount of rental real estate losses attributable to real estate professionals who materially participate. This was accomplished by targeting tax returns of resident taxpayers (Form 540) with a current year net loss in excess of $2,500 from rental real estate activities with active participation, and with positive taxable income.

This selection assumes: (1) taxpayers with losses of less than $2,500 are unlikely to be real estate professionals, and (2) real estate professionals are unlikely to have other passive activities generating net income sufficient to offset any significant rental real estate losses.

For returns matching the selection criteria, net losses from rental real estate activities with active participation, reduced by the special allowance, were tabulated, compared, and limited to amounts reported as state and federal differences for certain categories of income shown in Schedule CA. The resultant amount is used as a proxy to represent nondeductible passive losses (from rental real estate activities with active participation) of real estate professionals.

A series of adjustments was applied to the proxy amount to derive the additional amount that would be deductible under this proposal. Reductions were made for the complexity of applying properly the tests for determining a real estate professional and material participation, and the amount of suspended losses treated as from former passive activities and not deductible as nonpassive losses under this proposal.

For PIT purposes, applying an 8% marginal tax rate derives an estimated loss at 1996 levels of $7 million. The 1996 impact was grown by the projected rate of inflation to derive the 1999 and subsequent year levels.

The B&C tax estimates, also based on original federal projections, have been reduced proportionately with the reduction in PIT estimates.

BOARD POSITION

Neutral. At its March 23, 1999, meeting, the Franchise Tax Board voted 2-0 to take a neutral position on this bill.